

III. 1994 Audited Financial Statements

"...field-level managers and operators must continue to be educated on the importance, and long-term benefits, of the new information reporting requirements which support the proprietary financial management process."

— *Mr. Francis E. Reardon, Auditor General of the Army*

This section provides a summary of functional and financial management activities as they relate to the development of audited financial statements. It includes highlighted information from the FY 1994 audited financial statements.

The Relationship Between Financial Statements and the Budget Process

The budget formulation and execution process traditionally has been the primary vehicle for planning and managing Federal financial resources. The requirement for organizations such as the Army to produce proprietary financial statements is less than five years old.

Today, there are few direct relationships between Federal budgets and financial statements. One of the greatest challenges for the Federal financial community is to enhance the utility of both documents by relating them as appropriate. Characteristics of Federal budgets and financial statements — purpose, timing, measurement, and content — are demonstrated in Figure III-1.

Characteristics of the Budget vs. Financial Statements		
Characteristic	Budget	Financial Statements
Purpose	Primarily a prospective planning tool. Translates policy objectives into resource spending levels.	An actual accounting of how resources were utilized.
Timing	The Executive Branch budget process for FY 1996 is in its final stages by February 1995.	Issued after the budget process for the next fiscal year is largely completed. For example, the financial statements for FY 1994 are due on March 1, 1995. Thus, the financial statements are not available for developing the FY 1996 budget.
Measurement	Cash basis measurement. Obligations (encumbrances) for orders placed and goods or services requested are generally recorded, with certain exceptions. Outlays are recorded when obligations are paid. Receipts generally are recorded when checks are received.	Accrual basis measurement. Expenses are recorded when the government incurs a liability to pay for goods and services, and revenues are recorded when they are earned.
Content	Appropriation accounts are the budget vehicle for most Federal agencies and are generally organized by function.	Financial statements are organized by reporting entity. A reporting entity includes all the revenues and costs associated with an entity's activity, including budgetary appropriations and related salaries and other cross-functional overhead expenses.

Figure III-1

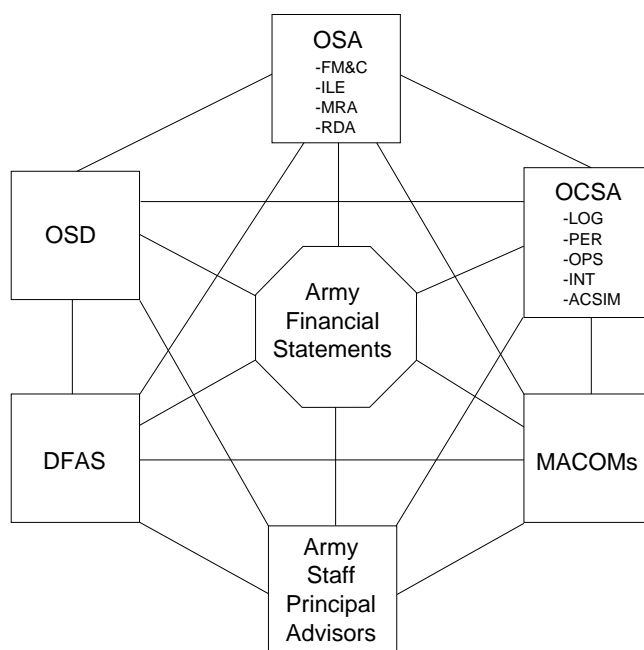
The inconsistencies between the financial statement preparation process and the budget formulation and execution process exemplify many of the difficulties the Army and other agencies have in developing auditable financial statements. Many of the existing budget-based and functional systems are designed to accommodate the budget process, but not the financial statement process.

Financial Statement Preparation Process

The Army and the Defense Finance and Accounting Service – Indianapolis (DFAS-IN) prepare the fina-

ncial statements using consolidated data from various functional and financial activities. DFAS-IN reconciles the Army's general ledger, status, and expenditure data. The general ledger becomes the basis for preparing the financial statements. The key participants in the financial statement preparation process are the Office of the Secretary of the Army (OSA), the Office of the Secretary of Defense (OSD), DFAS, the Office of the Chief of Staff of the Army (OCSA), the Major Army Commands (MACOMs), and the Army Staff Principal Advisors, as shown in Figure III-2.

Figure III-2

Financial Statement Data Relationships

OSD, Defense Agencies and all components of the Army contribute to the financial statement preparation process.

Discussion of the Financial Statements and Annual Financial Report

The Army's FY 1994 Annual Financial Report (AFR) consists of four main sections based on the OMB and DoD requirements and guidelines on form and content of financial statements.

These four AFR sections are summarized in Figure III-3 and highlighted in this discussion.

Department of the Army Annual Financial Report Summary
Section 1. Overview — Overview of Army's missions, performance, and financial management issues.
Section 2. Principal Statements — Financial Statements and Notes that present the Army's financial status at the end of the fiscal year and summarize resources that flowed in and out of the Army during the year.
Section 3. Audit Opinion — Auditor's Report on the fairness of the financial statement presentation.
Section 4. Supplemental Financial and Management Information — Supplemental Financial and Management Information for additional program and performance information not included elsewhere in the AFR.

Figure III-3

Overview

The Overview describes the Army's missions, functional activities, accomplishments, and financial management issues. Contents of the 1994 Overview are summarized in Figure III-4.

Principal Statements

The Financial Statements and Notes are the end product of Army and DFAS-IN data compilation efforts. Under current OMB guidance, Federal agencies are required to produce four statements,

Summary Contents of the Overview	
Section 1, "America's Army,"	describes how the Army's mission has changed and expanded in recent years, FY 1994 significant events, and the hard choices and resource challenges facing the Army.
Section 2, "Army Missions and Performance,"	describes the six major functions that support the Army's principal mission of total force readiness — force structure, manning, equipping, training, mobilization and deployment, and sustaining the force. Goals, objectives, and performance measures are included.
Section 3, "Financial Management Issues,"	discusses financial management challenges facing the Army, including accounting systems, cash and debt management, and budget execution issues.

Figure III-4

supported by explanatory notes. Three of these statements are similar in nature to private-sector counterparts. The fourth statement is unique to the Federal government. Figure III-5 provides a synopsis of each statement and shows the relationship to equivalent private-sector statements.

Federal Financial Statement	Purpose	Private-Sector Counterpart
Statement of Financial Position	Presents the assets, liabilities, and net position of an organization on the last day of the reporting year.	Balance Sheet
Statement of Operations and Changes in Net Position	Summarizes the sources of the organization's financial resources and how they were utilized for the reporting year.	Income Statement
Statement of Cash Flows	Summarizes the cash inflows and outflows and the changes in cash or cash equivalents for the reporting year.	Statement of Cash Flows
Statement of Budget and Actual Expenses	Provides a comparison and reconciliation of the organization's fiscal year transactions reported in budgetary reports to expenses reported on the Statement of Operations.	No private-sector counterpart

Figure III-5

The Notes to the Financial Statements (Notes) are an integral part of the Financial Statements. They contain additional information necessary to make the statements more informative. They contain explanations of accounting principles and provide additional quantitative and qualitative data.

Many activities performed by the Federal government are different from those performed in the private sector. As a result, the terminology used in the financial statements to report those activities may differ from private-sector terminology. Figure III-6 provides some examples of line items that are unique to the Federal government or that require further explanation.

Federal Financial Statement Line Item	Explanation
Fund Balance with Treasury	The aggregate amount of the entity's accounts with Treasury for which the entity is authorized to make expenditures.
Unexpended Appropriations	The amount of the entity's appropriations represented by undelivered orders and unobligated balances.
Invested Capital	The net investment of the government in the entity.
Program or Operation Expenses	Expenses incurred in conducting the normal activities of the department/agency.
Cost of Goods or Services Sold	Costs incurred to produce products sold or provide services to the public and other Federal entities. Over 80 percent of the Army's sales and related costs were intragovernmental.

Figure III-6

The following sections present key information from each statement that may be useful to functional managers.

• *Statement of Financial Position*

A summarized Statement of Financial Position for FY 1994 as compared to FY 1993 is provided in Figure III-7.

<i>Comparative Statements of Financial Position</i> <i>(all amounts in millions)</i>		
Assets	<u>FY 1994</u>	<u>FY 1993</u>
Fund Balance with Treasury	\$30,865	\$34,382
Accounts Receivable	1,094	1,626
Inventory	2,010	2,816
Property, Plant and Equipment	160,372	159,178
Stockpile Materials	30,461	35,037
Other Assets	<u>8,896</u>	<u>10,006</u>
Total Assets	<u>\$233,698</u>	<u>\$243,045</u>
Liabilities		
Accounts Payable	\$2,580	\$5,394
Accrued Payroll	1,427	3,195
Other Liabilities	<u>3,729</u>	<u>3,429</u>
Total Liabilities	<u>7,736</u>	<u>12,018</u>
Net Position		
Unexpended Appropriations	\$28,855	\$30,144
Invested Capital	199,761	198,066
Cum. Results of Operations	(1,052)	4,435
Other	404	480
Future Funding Requirements	<u>(2,006)</u>	<u>(2,098)</u>
Total Net Position	<u>225,962</u>	<u>231,027</u>
Total Liabilities and Net Position	<u>\$233,698</u>	<u>\$243,045</u>

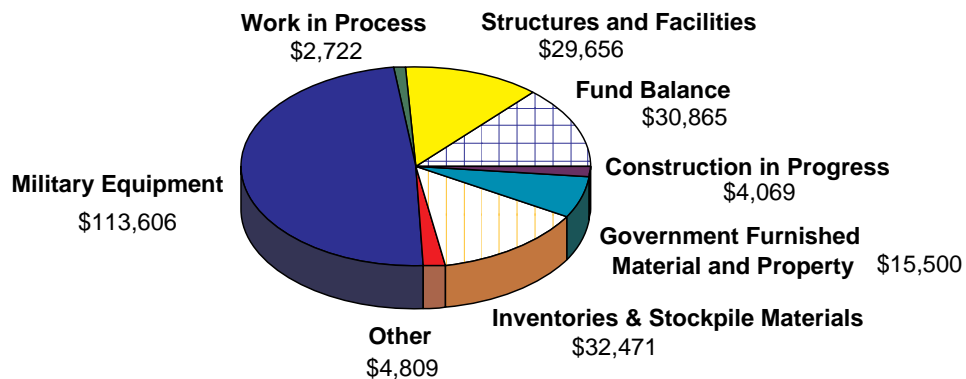
Figure III-7

Total assets remained relatively stable during 1994. A breakout of total assets as shown in the statement and related Notes is shown in Figure III-8.

Figure III-8

Breakdown of Total Assets

(in millions \$)



Almost half of the Army's assets is military equipment.

In the Net Position section, the Future Funding Requirements of \$2.0 billion represent accrued liabilities, such as civilian and military annual leave earned but not taken, that are not funded when accrued. Instead, these liabilities are funded and expensed in the period the payments are made. Almost 90 percent of this liability consists of annual leave.

• *Statement of Operations and
Changes in Net Position*

A summarized Statement of Operations and Changes in Net Position for FY 1994 is presented and compared to FY 1993 in Figure III-9.

<i>Comparative Statements of Operations and Changes in Net Position</i> (all amounts in millions)		
Revenues and Financing Sources	<u>FY 1994</u>	<u>FY 1993</u>
Appropriated Capital Used	\$55,610	\$57,425
Other Revenues and Financing Sources	<u>6,796</u>	<u>6,339</u>
Total Revenues and Financing	\$62,406	\$63,764
Expenses		
Program or Operation Expenses	\$56,136	\$59,006
Cost of Goods Sold	6,289	6,338
Bad Debts and Write-Offs	55	21
Other Expenses	<u>2,975</u>	<u>46</u>
Total Expenses	\$65,455	\$65,411
Excess (shortage) of Revenues and Financing Sources over Total Expenses	<u>\$(3,049)</u>	<u>\$(1,647)</u>

Figure III-9

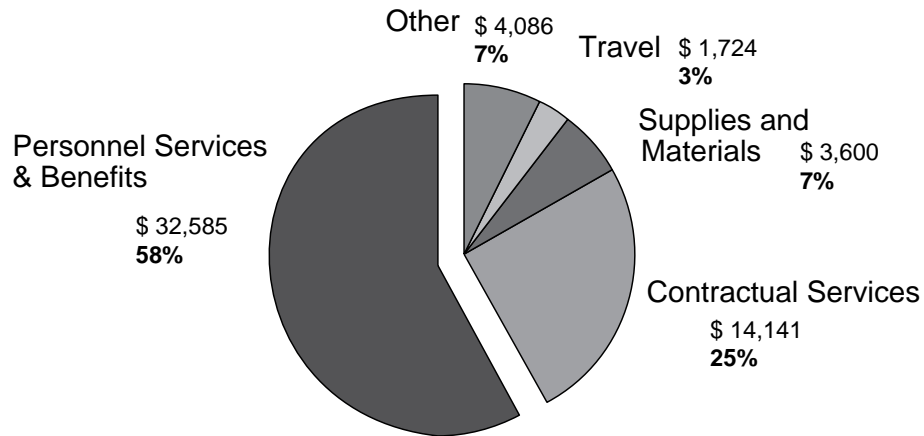
The Army's revenues and expenses are nearly equal. The Army, as most Federal agencies, relies on Federal appropriations to fund its current activities, and no significant difference between revenues and expenses is expected.

Program or Operation Expenses are almost 90 percent of total expenses. These expenses decreased 4.9 percent during 1994, continuing a downward trend. Personnel Services and Benefits constitute 58 percent of Program expenses, thus making people the Army's largest investment. The major categories of expenditures are shown in Figure III-10. Figure III-11 illustrates the downward trend in Program expenses.

Figure III-10

FY 1994 Program Expenses

(in millions \$)

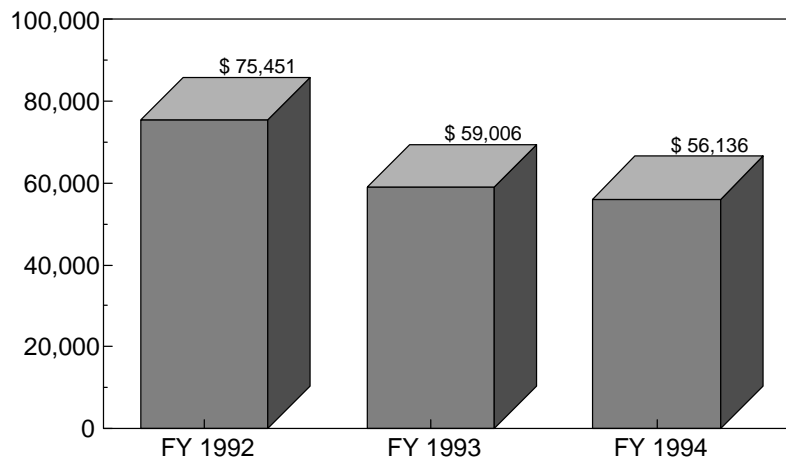


People are the Army's largest investment.

Figure III-11

Program Expenses FY 1992-1994

(in millions \$)



The Army's program expenses are trending downward as the Army manages the mandates imposed by Congress.

• *Statement of Cash Flows*

A Summary Statement of Cash Flows for FY 1994 and compared with FY 1993 is presented in Figure III-12.

<i>Comparative Statements of Cash Flows</i> (all amounts in millions)		
Cash Provided (Used) by Operating Activities	FY 1994	FY 1993
Sales of Goods and Services	\$6,287	\$7,649
Personnel Services and Benefits	(38,196)	(40,344)
Other Contractual Services	(11,387)	(13,401)
Other Operating Cash Used (Other Operating Expenses Paid)	<u>(10,744)</u>	<u>(15,320)</u>
Net Cash Provided (Used) by Operating Activities	<u>\$(54,040)</u>	<u>\$(61,416)</u>
Cash Provided (Used) by Investing Activities		
Purchase of Property, Plant and Equipment	<u>\$(11,769)</u>	<u>\$(10,510)</u>
Cash Provided (Used) by Financing Activities		
Net Appropriations (Received)	<u>\$62,287</u>	<u>\$66,020</u>
Net Cash Provided (Used) by Operating, Investing and Financing Activities	<u>\$(3,522)</u>	<u>\$5,906</u>

Figure III-12

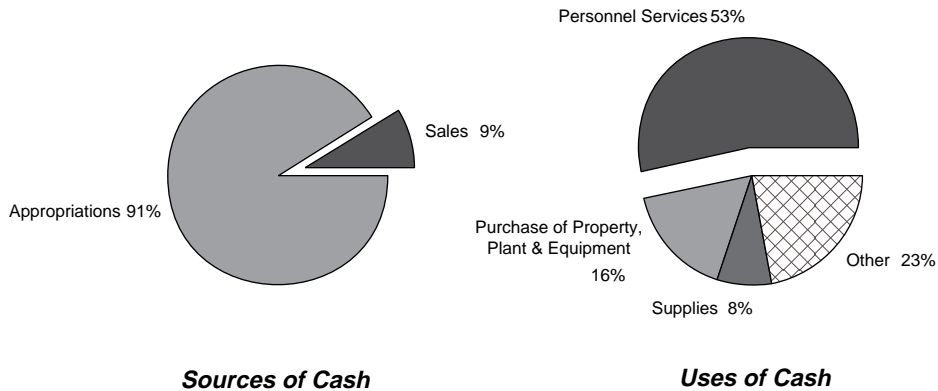
Cash receipts and disbursements are shown by operating, investing, and financing activities. Operating activities generally involve completing Army missions, producing goods and providing services. Investing activities principally include the acquisition and manufacture of weapon systems and productive assets used in accomplishing Total Force Readiness. Financing activities consist of Congressional appropriations.

In FY 1994, cash used for operating activities decreased 14 percent, cash used for investing activities increased 12 percent, and net appropriations decreased 6 percent. This reflects reduced funding and a smaller Army.

Almost all of the Army's cash comes from Congressional appropriations, and the largest cash expenditure item is personnel services, as shown in Figure III-13.

Figure III-13

Major Sources and Uses of Cash



Most of the Army's cash comes from appropriations, and the largest cash expenditure item is personnel services.

• *Statement of Budget and Actual Expenses*

The Statement of Budget and Actual Expenses provides a comparison of actual expenses incurred by the Army with the budget authority for those expenses. The DoD Guidance on Form and Content defines a program as fund type (general, revolving, or trust). Fund types for the Army primarily relate to the method for financing programs and missions through annual and multi-year appropriations provided by Congress.

For the first time in developing financial statements, the Army and DFAS-IN modified the statement to present financial programs and make the statement

more informative for program managers. The following appropriations were included in the general fund program break-out:

- Military Personnel
- Operations and Maintenance
- Procurement
- Construction
- Research, Development, Test and Evaluation (RDT&E)
- Miscellaneous

This break-out provides data for linking budgetary and financial statement information.

• *Notes to the Financial Statements*

The Notes contain a significant amount of quantitative and qualitative information that provides additional perspective as to the absolute amounts in the financial statements. Some of the information from the Notes has been used in the preceding discussions of the financial statements. Additional information is highlighted below.

Note 2, Commitments and Contingencies

Information in this Note describes potential liabilities that may require additional funding to liquidate. Because these potential liabilities are not a certainty or cannot be estimated reliably, they are not reflected as “true” liabilities in the financial statements. In accordance with DoD policy, the Army identifies these potential liabilities in the Notes. Figure III-14 summarizes the areas where the Army has determined significant contingent liabilities may exist.

FY 1994 Contingent Liabilities	
(in millions \$)	
Environmental Compliance	\$20,778
Rightsizing	2,096
Workman's Compensation	1,496
Base Realignment	955
Radioactive Waste	415
Re-enlistment Bonuses	154

Figure III-14

Note 11.C, Reportable Anti-Deficiency Act (ADA) Violations

This Note includes a discussion of Reportable ADA Violations. There are currently 14 ADA Violation cases under review, representing an aggregate total of \$219.7 million. One case constitutes \$208 million of the total.

Audit Reports

Under Government Auditing Standards, independent auditors are required to report on (1) the financial statements, (2) internal controls, and (3) compliance with applicable laws and regulations. The annual audits are valuable because they include a comprehensive evaluation of the effectiveness of the Army's financial systems and internal controls leading to the auditor's report on internal controls. The internal control report sets forth reportable conditions and material weaknesses and includes the Army's progress in addressing those matters.

FY 1994 is the fourth consecutive year the Army has undergone a financial statement audit. Auditors were unable to express an opinion on the

financial statements for the first three years. The current auditor, the U.S. Army Audit Agency (AAA), was also unable to express an opinion on the Army's FY 1994 financial statements, primarily because the accounting systems that support the financial statements do not have an integrated general ledger or produce comprehensive subsidiary ledgers.

The problem areas cited by the auditors in their report are similar to those found in many Federal agencies. Accounting system deficiencies are the most common issue reported by auditors of Federal financial statements. Figure III-15 describes the progress by the Army and DFAS during FY 1994 in key areas identified in the AAA's opinion.

“The Army and the Defense Finance and Accounting Service continued to make progress on their commitments to effectively and efficiently manage and account for the Army’s resources. However, we also identified areas where significant improvements and more emphasis are still needed.”

— AAA Audit Opinion

Authoritative Guidance

The FASAB, which provides authoritative guidance for all Federal accounting and financial reporting practices, is developing a series of accounting and financial reporting pronouncements to clarify authoritative guidance issues. Three pronouncements have been issued in final, and four are currently being circulated for comment.

OMB's Form and Content guidance will be updated when the current set of FASAB pronouncements is complete. One of the major pronouncements has been issued as an Exposure Draft, "Entity and Display," which proposes sweeping changes to Federal financial statements. Under the Exposure Draft, the four current statements would be

Status of Audit Findings Identified in the Audit Report	
Progress Made During FY 1994	
Significant Progress Made	
<ul style="list-style-type: none"> • Improved procedures and controls used by DFAS-IN to prepare financial statements. • Resolved record retention problems within the accounting system used by the U.S. Army Materiel Command. • Continued efforts to develop interfaces between the Active Army personnel and payroll systems. • Continued development of property book systems for retail military equipment that will interface directly with the accounting systems. 	
Measurable Progress Made – More Work Remaining to Improve Data Reliability	
<ul style="list-style-type: none"> • Corrected some accounting problems related to outstanding advances and prepayments. More work is needed to improve reporting controls. • Added transaction tracking capabilities to a major accounting system. Additional improvements are needed to automate the recordkeeping changes. • Improved wholesale equipment management by taking steps to protect depot stocks from the weather and from theft. Procedures and controls over financial reporting for wholesale equipment and munitions need significant improvement. 	
Little Change Since Last Audit	
<ul style="list-style-type: none"> • Dollar values reported for government-furnished property were still unauditable. • DoD policies concerning contingent liabilities and other disclosures continue to prevent the Army from accurately reporting its liabilities. • Real property records have not been validated and reconciled to corresponding accounting records. 	

Figure III-15

replaced by six statements. These new statements are described in Figure III-16. The most significant aspect of these new reporting requirements is the increased emphasis on stewardship and accountability.

Proposed Entity & Display Financial Statments	
Proposed Statement	Purpose of New Statement
Balance Sheet	Similar to the current equivalent report.
Statement of Operations	Similar to the current report; however, the new statement is simplified and information more clearly presented.
Statement of Investment in Other Physical and Human and Intellectual Capital	This new statement would provide stewardship reporting for items previously reported on the balance sheet, e.g., weapons systems and human and intellectual capital investments not reported in financial statements.
Statement of (Changes in) Selected Future Claims on Resources	This new statement would present the changes during a period in the balances of selected claims. In some instances, it might be more practical to display the selected future claims in other than dollar amounts.
Statement of Budgetary Resources	This new statement would provide the budgetary perspective on the current year financial results.
Statement of Program Performance Measures	This new statement would quantify already required information into one concise report.

Figure III-16

FASAB has issued other Exposure Drafts, including "Managerial Cost Accounting Standards for the Federal Government," "Accounting for Liabilities of the Federal Government," and "Accounting for Property, Plant and Equipment." Collectively, these pronouncements, when finalized, will make sweep-

ing changes in the Army's financial reporting requirements.

As the Army moves forward in enhancing its financial management reporting and financial statement preparation process, staying abreast of updates in authoritative guidance is essential.

IV. Other Financial Management Initiatives

The Army's FY 1994 AFR reported on the status and progress of other financial management initiatives. These initiatives will help the Army improve financial management and stewardship of resources. Information from the AFR is summarized in this section.

Accounting Systems

Accounting systems are a critical component of the financial statement process. The primary reason the Army's auditors have been unable to render an opinion on the financial statements is that the accounting systems that support the financial statements do not have an integrated general ledger. Deficiencies related to accounting systems are the most pervasive financial management problem in the Federal government.

Accounting systems issues are summarized in Figure IV-1.

Figure IV-1

Accounting Systems

- The Army is transitioning from multiple individual unique systems to selected interim migratory and standard migratory systems.
- The Army's goal for the future is a single integrated financial management system.
- The Army and DFAS-IN are phasing in direct reporting for budget execution data.

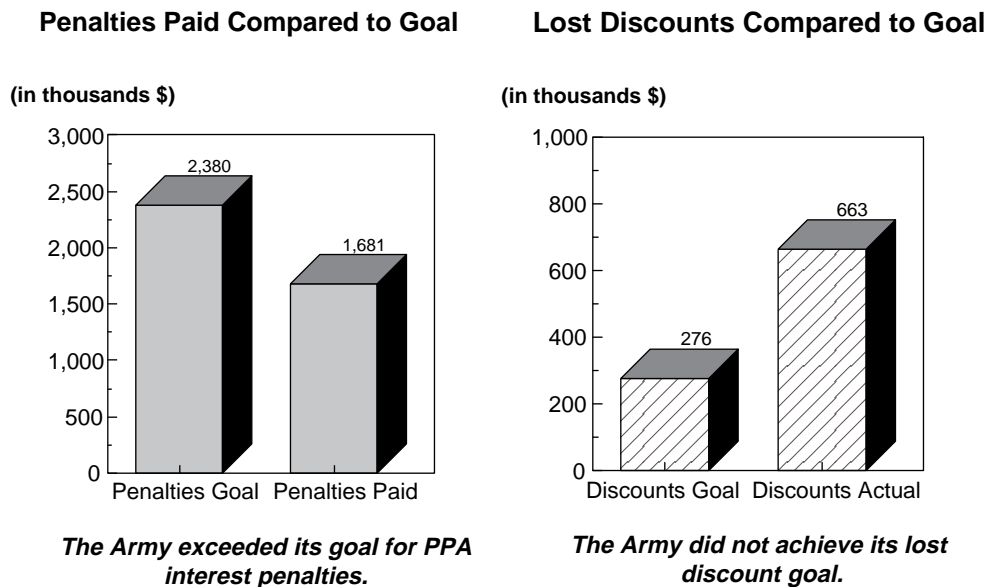
Cash Management

Cash management goals include minimizing Prompt Payment Act (PPA) interest penalties paid to customers and ensuring that lost discounts are kept as low as possible. The Army has begun initiatives to reduce requirements and improve management of cash held.

PPA interest penalty and lost discount program performance measures are illustrated in Figure IV-2. The Army exceeded its goal for PPA interest penalties by incurring interest penalties on only .01 percent of the total amount of disbursements subject to PPA. The lost discount goal of losing no more than 2 percent of the total amount of discounts offered subject to PPA was not achieved.

Figure IV-2

Cash Management Performance



Debt Management

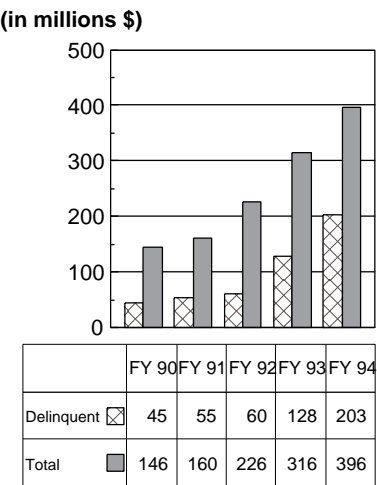
The Army's public debt has grown dramatically as a result of demobilization and the rapid reduction in the Armed Forces. Debt management issues are summarized in Figure IV-3.

Improving debt management is important to managers because resources spent on collecting delinquent receivables and on write-offs could be used for other purposes. Figure IV-4 illustrates the opportunity costs of these write-offs.

Figure IV-3

Delinquent and Total Receivables

- The Army's public debt is increasing.
- Debt from former soldiers is 64 percent of total delinquent public receivables.
- The Army is making policy and systems improvements to increase efficiency of debt collection.



The Army's public debt is increasing.

Figure IV-4

\$44.2 Million in
Accounts Receivable
Write-offs

=
48 Bradley M3A1
Fighting Vehicles



Delinquent receivables that are written off and absorbed draw budgetary authority away from other potential uses.

Based on October 1994 AMDF

Canceled Appropriations and Unmatched Disbursements

“Canceling appropriation liabilities are a financial management problem that, if left unattended, will reduce the Army's execution year purchasing power.”

— Joe R. Reeder, Under Secretary of the Army

Issues related to canceled appropriations and unmatched disbursements are summarized below in Figure IV-5.

Figure IV-5

Canceled Appropriations and Unmatched Disbursements

Canceled Appropriations

- Public Law 101-510 requires that all appropriations have a defined life cycle after which detailed appropriation data must be maintained until all liabilities have been eliminated.
- The Army reduced FY 1994 canceling year liabilities from \$510 million to \$11.2 million by implementing a Joint Reconciliation Program on an Army-wide basis.

Unmatched Disbursements

- Unmatched Disbursements affect the accuracy of accounting reports because obligations are not accurately stated.
- The Army reduced unmatched disbursements 59 percent from the June 30, 1993, level of \$1.2 billion to \$486 million on June 30, 1994.

V. Continuing Process Improvements

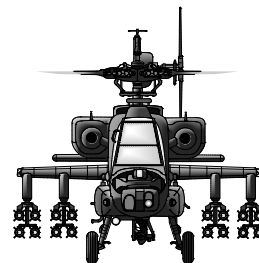
“Force XXI ... will be a force organized around information and information technologies. Its purpose will be to deter those who oppose us, to compel when deterrence fails, and to reassure our friends and allies around the world that they can count on us. It will also stand ready to support disaster relief and humanitarian efforts within our own land. We must win the first battle ... whatever it is.”

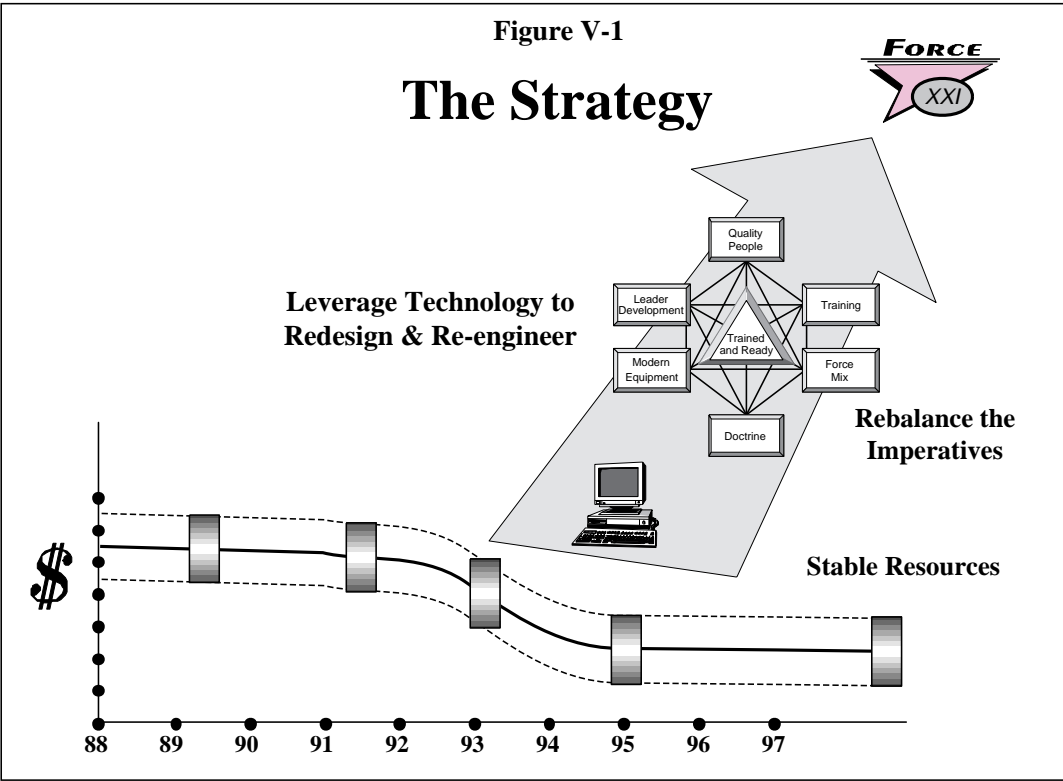
— Joint Statement by the Secretary of the Army and the Chief of Staff of the Army

The Army is reinventing financial management in order to support its strategic objectives. Figure V-1 summarizes the Army's view of continuous change to accomplish its goals for the 21st century. As the Figure depicts, resources have continued to decline over the past seven years, but are anticipated to begin to stabilize in FY 1995. At the same time, the Army is leveraging technology to rebalance imperatives and accomplish more, a redesigned force in Force XXI, with reduced resources.



Continued efforts to enhance financial management and improve supporting business processes are paying off. The Army's leadership recognizes that if the CFO Act requirements and financial management improvements are in place, the Army can achieve its vision of Force XXI.





This document is designed to be a companion guide to the 1994 Annual Financial Report.

The document was developed jointly by the Office of the Assistant Secretary of the Army - Financial Management, the Defense Finance and Accounting Service - Indianapolis Center, and Coopers & Lybrand L.L.P. Questions related to this document or the 1994 Annual Financial Report should be addressed to:

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